*United States Court of Appeals*

*for the Second Circuit*

# BRIEF FOR APPELLANT

# 76-7565

# United States Court of Appeals

FOR THE SECOND CIRCUIT

PITTSBURGH COKE & CHEMICAL COMPANY,

*Plaintiff-Appellant,*

—against—

LOUIS J. BOLLO,

*Defendant-Appellee.*

## BRIEF OF PLAINTIFF-APPELLANT

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## BRIEF OF PLAINTIFF-APPELLANT

This is an appeal from a judgment entered in favor of defendant-appellee Louis J. Bollo ("Bollo") by the United States District Court for the Eastern District of New York, Honorable Edward J. Neaher, U.S.D.J., after a non-jury trial. The trial was concluded on October 21, 1974; on October 19, 1976, the district court rendered its opinion[1] from which this appeal is taken.

Plaintiff-appellant is Pittsburgh Coke & Chemical Company ("PCC"), a diversified management investment company registered under the Investment Company Act of 1940. PCC is the successor in interest to First Grant Corporation,[2] also an investment company. The suit arises out of the sale by Bollo to PCC of a majority interest in the stock of Standard Aircraft Equipment Company

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[1] The opinion has not yet been officially reported. It is reprinted at pages 830-87 of the Joint Appendix. Part of the opinion (JA 830-63) was reported in [Current] Fed. Sec. L. Rep. (CCH) ¶ 95,746.

[2] On February 19, 1971, First Grant was merged into PCC, its parent (JA 893). This brief will adopt the style of the trial court's opinion and use "PCC" to refer to First Grant as well as Pittsburgh Coke & Chemical Company.

("Standard"), a distributor of spare parts for aircraft, for a sum in excess of $3.6 million. Bollo was the founder and, until September 1969, the chief executive and operating officer and controlling shareholder of Standard.

The agreement between PCC and Bollo to purchase the shares (JA 897-917) was signed on December 20, 1968 and, pursuant to its terms, was subject to a number of conditions, including the obtaining of exemptions or approval by the Civil Aeronautics Board and the Securities and Exchange Commission, and the continued truthfulness and correctness as of the date of the closing of representations and warranties made in the December 20, 1968 agreement. The transaction was closed on September 18, 1969.

Two issues are raised by the appeal. The first (discussed at pp. 21-39, *infra*) is whether the trial court correctly denied recovery to PCC on its claim for securities fraud under Section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 thereunder. Central to the decision of the trial court in this respect was its refusal to consider Bollo's failure to disclose a variety of what the court itself acknowledged were "adverse developments" which "followed rapidly upon the signing of the December, 1968 agreement" (JA 845) and occurred prior to the closing. Those developments included the deterioration and virtual destruction of relationships between Standard and its largest suppliers —a deterioration which led, only 11 months after the closing, to an almost complete termination of Standard's relationship with its three largest suppliers. The trial court nonetheless concluded that there could be no recovery, since:

> For purposes of a Rule 10b-5 claim, events occurring after the commitment to purchase stock has been made are irrelevant. Issues of non-disclosure, misrepresentation, materiality and reliance are to be determined by the situation and knowledge of the parties at the time they committed themselves, and not on the basis of subsequent events, even though they occur prior to "the

> formal closing date when the delivery and payment are formally completed and cleared." *Radiation Dynamics, Inc.* v. *Goldmuntz,* 464 F.2d 876, 890 (2d Cir. 1972).

(JA 860-61). PCC believes this legal conclusion was utterly incorrect; that the trial court's reliance upon the decision of this Court in *Radiation Dynamics* was, as applied to this case, misplaced; and that this critical error of law warrants reversal of the decision below.

The second issue (discussed at pp. 40-49, *infra*). is whether the trial court correctly concluded that Bollo had not breached express warranties he had made that the financial statements of Standard had been prepared in accordance with generally accepted accounting principles. Two expert witnesses testified that the inventory of Standard was overstated by *at least* $380,000 as of the date of the closing; no contrary testimony was adduced by defendant. Nonetheless, the trial court held that Bollo had not breached his express warranties in both the December 20, 1968 agreement and the subsequent closing certificate. PCC submits that this holding was erroneous and totally unsupported by the evidence in the case and therefore should be reversed.

## ISSUES PRESENTED

(1) Was the trial court correct in holding that the failure of a seller of shares to disclose material events that occurred between the date of entering into a contract and the date of its closing nine months later did not and could not lead to liability under the federal securities laws?

(2) Was the trial court correct in holding that the seller had not breached his warranty that the financial statements of the company, the shares of which were being sold, were prepared in accordance with generally accepted accounting principles when all the testimony was to the contrary?

## SUMMARY OF THE EVIDENCE[3]

### A. The Sale of Standard

During 1967, PCC acquired roughly 25% of the outstanding shares of Standard.

On December 20, 1968, following extended negotiations, Bollo entered into a contract (JA 897-917) with PCC pursuant to which PCC made a tender offer (JA 1254-57) on December 31, 1968 to the stockholders of Standard (other than Bollo) at $16 per share. In response, 71,309 shares (roughly 16% of the shares of the company) were tendered, for which PCC paid $1,140,944.[4]

Pursuant to the other provisions of the contract, PCC purchased from Bollo at $16 per share 171,302 shares or roughly 39% of the total shares of the company on September 18, 1969 for $2,740,832, and at $12 per share 79,042 shares or roughly 18% of the shares of the company on August 4, 1970 for $948,504. Pursuant to the 1968 agreement, therefore, PCC paid a total of $4,830,280 for 321,653 shares of Standard, or roughly 72.5% of Standard's 443,700 total shares. Of that amount, PCC paid Bollo $3,689,336 for 250,344 shares.

The December 20, 1968 contract (JA 897-917) contained several warranties and representations of Bollo designed to protect PCC. Paragraph 2(e) warranted:

> There have been furnished to Purchaser financial statements of Standard, consisting of balance sheets as of December 31, 1965, December 31, 1966, and December 31, 1967, and income statements and related notes for the years ending December 31, 1965, Decem-

[3] Where relevant, we deal with the Court's conclusions as to the evidence in the ARGUMENT section of this brief.

[4] This amount was paid as follows: $1,085,472 on March 4, 1969; $5,872 on March 7, 1969; and $49,600 on September 15, 1969. The tendering shareholders had the right to withdraw their tenders after March 1 (JA 1255).

ber 31, 1966, and December 31, 1967, accompanied in each instance by the opinion of Byrnes & Baker, Certified Public Accountants, and a balance sheet as of September 30, 1968 and an income statement for the nine-month period then ended, prepared from the books and records of Standard without audit. Except as otherwise specifically set forth in said statements or in the accompanying accountants' certificates, *all such financial statements have been prepared in accordance with generally accepted accounting principles* applied on a consistent basis throughout the periods involved. All such statements fairly present the financial position of Standard as of the dates thereof and the results of operations for the periods indicated.

(JA 899-900).[5] Paragraph 2(f) warranted:

> Since December 31, 1967, there has been *no material adverse change* in the financial condition or in the business or operations of Standard.

(JA 900). Paragraph 6(d) provided:

> *The representations and warranties* contained in Paragraph 2 of this Agreement *shall be true and correct as of the Closing Date, with the same force and effect as though they had been made at the Closing Date,* and there shall have been delivered to Purchaser the certificate of Bollo, President of Standard, dated the Closing Date to such effect . . . .

(JA 904). Paragraph 9 provided:

> All representations of Bollo contained in Paragraph 2 hereof shall survive the closing. *Bollo covenants and agrees to indemnify and hold Purchaser harmless from any and all loss or damage incurred by Purchaser by reason of the breach of any of the repre-*

[5] All emphasis found in quotations in this brief has been added by us unless specifically noted to the contrary.

> *sentations and warranties* set forth in Paragraph 2 hereof. . . .

(JA 906).

The agreement further stipulated that PCC's obligation to close the agreement with Bollo was expressly conditioned upon obtaining an exemption from the Securities and Exchange Commission (because of PCC's investment company status) and either exemption or approval from the Civil Aeronautics Board (because of PCC's prior acquisition of American Flyers, an air carrier authorized to operate charter passenger and cargo flights) (JA 902-03). The December 20, 1968 agreement set a closing date of no later than June 30, 1969 (JA 901). Due to delays in obtaining SEC and CAB clearances, the contract was not closed until September 18, 1969 (JA 839).

Pursuant to Paragraph 6(d) of the December 20, 1968 agreement, Bollo provided to PCC at the closing on September 18, 1969 the certificate (JA 918-21) required to consummate the transaction. The relevant sections of that certificate contained warranties for PCC's protection including a warranty (JA 919) identical to paragraph 2(e) of the agreement (*supra*) as well as paragraph 1(f) which provided:

> Since December 31, 1967, *there has been no material adverse change* in the financial condition of the company as evidenced by most recent balance sheet information except that, as you know, earnings in 1969 have been reduced due primarily to the investment in start up expenses of our Kansas City operation.

(JA 919-20).

**B. The Business of Standard**

Standard was founded in 1933 by Bollo and incorporated in 1947. Bollo controlled the company, either as the sole

proprietor or as controlling shareholder and president of the company from its founding until September 18, 1969 (JA 831-32).

Standard was a distributor of aircraft parts and acted essentially as a middleman, buying aircraft parts from manufacturers (frequently referred to as "suppliers") and selling them to airlines and other owners of airplanes (JA 99). Standard was not the only source for any particular aircraft part, because a customer could go either to the manufacturer or to another distributor for the part. Standard's selling price to its customers was, in most cases, spelled out in agreements with the manufacturers (JA 561-62). Standard's business and profitability thus depended upon the willingness of manufacturers to give it a discount, *i.e.*, to sell their parts to Standard at a price substantially lower than the price at which the parts would be sold to the airlines or other customers of Standard (JA 101-02).

The difference between (a) Standard's price to the airlines or other customers and (b) its cost of sales (the cost of buying the product from the manufacturer) is called the "sales margin" or "margin of sales" or "gross profit" and is proportional to the size of this discount. From the cumulative sales margin on all parts that Standard sold, Standard obtained the money to pay its expenses (other than cost of sales) such as salaries, rent, etc. (JA 102).

A manufacturer would furnish Standard with its products at a discount in order to avoid the expense, difficulty and investment involved in maintaining its own distribution setup. If a manufacturer did not provide such a discount, Standard would not handle its products and that manufacturer would have to establish and maintain its own distribution system (JA 102-03).

Although Standard had acquired some 100 distributorships by 1960, the bulk of its sales and profits were concentrated in a few lines (JA 832). The three largest suppliers (JA 893-94) in 1968 were:

| | 1968 Sales | % of Total Sales of Standard |
|---|---|---|
| Bendix Energy Controls | 1,769,000 | 19.4 |
| Bendix Navigation & Control | 1,692,000 | 18.6 |
| Whittaker | 1,455,000 | 16.0 |
| Total | 4,916,000 | 54.0 |

Standard's contracts with its suppliers were generally terminable on as little as 30 days' notice (JA 832). The security of a distributorship arose, therefore, from the historical working relationship between Standard and the suppliers and not from the written distributorship agreements (JA 207-08).

To provide better access to the customer and to compete better with other distributors, Standard established branches in a number of cities. Much of Standard's business consisted of stockpiling inventory so that it could be readily furnished to a customer (JA 565-66).

During the period 1964-67, Standard's sales doubled and net profits tripled (JA 922-70). By the fall of 1968, the airlines were soon to begin flying the "second-generation" jet aircraft—the wide-bodied Boeing 747, McDonnell-Douglas DC-10 and Lockheed 1011. In the negotiations leading up to the December 20, 1968 contract, Standard's prospects for increased sales growth when these jets began service were "undoubtedly a frequent subject of discussion" (JA 866).

### C. Supplier Relationships (Argument Point I)

Standard's deteriorating relationships with its principal suppliers were the subject of considerable testimony and are central to the rule 10b-5 claim in the case.

### 1. *Whittaker Corporation*

Standard's single largest supplier in 1967—over 21% of Standard's total sales—was the Whittaker Corporation ("Whittaker") (JA 893-94). Whittaker, located in California, was a manufacturer of valves for airplanes.[6] Standard received a discount during this period of between 15 and 22% (depending on the size of Standard's monthly orders) of the price to the customer on all Whittaker products (JA 238-39). All the Whittaker products sold during this period were parts for propeller or first-generation jet aircraft (*e.g.*, 707, 727) (JA 239).

PCC was told by Bollo, during the negotiations for the contract, of Whittaker's central role to Standard. In a meeting with Bollo on September 25, 1968 (JA 983), Richard M. Johnston, then Assistant to the President of PCC, was told that the new 747 and other second generation[7] jet business would cause Whittaker sales to grow still further (JA 166-1). He was also told (as he contemporaneously recorded) that:

> Whittaker Corporation continues to be the largest supplier, and volume continues to rise dramatically and now approaches $1.8 million annually. These controls will appear on the big airplanes in quantities just as they are on the first generation jets. Standard remains exclusive distributor, and Lou sees no change in this situation.

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[6] Gross sales of Whittaker products by Standard during the years 1965-1968 and the percentage of total sales of Standard were as follows (JA 985):

| | *Gross Sales of Whittaker Products* | *% of Total Sales of Standard* |
|---|---|---|
| 1965 | $1,065,000 | 18.1 |
| 1966 | 1,139,000 | 17.3 |
| 1967 | 1,671,000 | 21.5 |
| 1968 | 1,455,000 | 16.0 |

(JA 983). Bollo confirmed having so advised Johnston (JA 714-16).

The testimony and documents further demonstrated that the supplier relationship with Whittaker had historically been unstable. Whittaker had cancelled the relationship for a short period in 1963 (JA 316-17); it had, in 1966, established its own division to distribute Whittaker parts (JA 253), a division Bollo understood would be in competition with the distribution facilities of Standard (JA 258, 986-89); in early 1967 Whittaker personnel had begun calling directly upon customers of Standard (JA 993, 250); in 1967 Standard received surreptitiously two internal memoranda (JA 986-1000) of Whittaker outlining plans to terminate the Standard distributorship; one of these (JA 990-1000) was entitled "Proposal for Cancellation of the Standard Distributorship Agreement and Absorption of this Business into Aircraft Components Division." Following the receipt of these memos, Jerry Bollo[8] and Louis Bollo discussed the possibility of a complete cut-off by Whittaker within two years (JA 246).

Johnston and others testified that the above were not disclosed to them at any time prior to the closing; Bollo did not disagree (JA 698-99). The court, however, held that these matters were not by themselves sufficient to justify liability.

Between the signing of the PCC-Bollo agreement and the closing, the following occurred:

1) In January 1969, Jerry Bollo and Ernest Rushia, Vice President of Materiel for Standard, visited Whittaker in California. While there, they were told, as recorded in

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[7] In this brief, the terms "wide-bodied" and "second generation" aircraft are used interchangeably to refer collectively to the Boeing 747, McDonnell-Douglas DC-10 and Lockheed 1011 jumbo jets.

[8] Jerry Bollo was the brother of Louis Bollo and, at all times relevant, Standard's Vice President in charge of Marketing. To avoid confusion, references in this brief to Jerry Bollo or his testimony will always be labeled "Jerry Bollo."

a contemporaneous memorandum of Jerry Bollo, that "On the Lockheed 1011 and the DC-10, the competitive situation is so great that in all probability [Standard] will not be handling either unit or spare parts support business on these aircraft. The 747 will probably be the same." (JA 1001, 261-62, 367).

Jerry Bollo testified that he discussed this with Louis Bollo (JA 262-63) and that, on February 6, 1969, Jerry Bollo received a TWX (JA 1003) from Whittaker which began "In accordance with our recent discussions with Harry White, it is Whittaker's intent to accomplish all initial provisioning for the 747 aircraft through the controls division."

Although the TWX mentioned only initial provisioning,[9] the TWX was understood, in light of the statements made to Jerry Bollo at Whittaker in January 1969, to apply to the follow-up support business as well[10] (JA 267-69). Louis Bollo at trial admitted seeing the TWX soon after it was received (JA 623).

2) The loss of the wide-body jet aircraft business would presage the loss of *all* the Whittaker business. Jerry Bollo testified he had so advised Louis Bollo (JA 270-71) and William Carolla, testifying as an expert,[11] confirmed that, based on the information in Standard's hands prior to the

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[9] "Initial provisioning" is the term used for the original supply of spare part equipment new aircraft must be provided with and maintain at locations along an airline's routes in order to obtain CAB certification of fitness of the aircraft for air travel.

"Spare orders" or "follow-up support" refer to subsequent need for replacement units and spare parts due to breakage or wearing of original units and initial spare parts (JA 881 n.8).

[10] Jerry Bollo testified that the TWX was "so interrelated with the preceding trip" that they were as a practical matter indistinguishable (JA 267).

[11] Carolla had been active in the field for over twenty years, president of the largest company in the industry and president of the Aviation Distributors & Manufacturers Association (JA 447).

closing, the loss of the Whittaker distributorship was likely (JA 495; *see* JA 460).

Witnesses from PCC testified that they were not told about the instability of the relationship, the internal Whittaker memos, the establishment of and marketing activities of the Aircraft Components Division, the definitive cut-off of products on the wide-body jets, or the pessimistic outlook for future Whittaker business. The most that was disclosed was the "possibility" that initial stocking "might" be performed by the manufacturer (JA 112).[12] Although Bollo testified that he "believed" PCC representatives were advised of the adverse Whittaker developments prior to the closing he could not recall doing so (JA 700, 704).[13]

On July 3, 1970, less than 11 months after the closing, Whittaker gave notice of cancellation of the distributorship agreement with Standard (JA 1066).

### 2. *Bendix Corporation*

During the 1965-68 period, the Bendix Corporation, through its ten divisions, accounted for roughly *half* the sales of Standard. The overwhelming importance of the Bendix divisions to the health of Standard was impressed upon PCC. In his memorandum (JA 983-84) reporting on a September 1968 meeting with Bollo, Johnston reported:

> The future looks most encouraging to Lou. The immediate prospect among the airline customers is the 747, which is loaded with Bendix equipment. Standard has traditionally had a strong position with Bendix. Included among the parts are wheels and brakes, all the electrical system, the autopilots and 50% of the instrumentation. Lou is confident that he will obtain

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[12] Indeed, Rod Bonar, who had been Assistant for Planning and Control at PCC, testified that, when he visited Standard in July 1969, Louis Bollo told him that the relationships with Bendix and Whittaker were "good" (JA 200).

[13] At his deposition, Bollo had conceded that he had not advised PCC of the pre-closing Whittaker developments (JA 701-02).

> much of the original ordering for airline provisions, and he has already received assurance from Pan American that they will handle all brakes and wheels through him. . . . No announcement has been made yet concerning parts for the Lockheed and Douglas air busses, but this is forthcoming in the next year.

Of the ten Bendix divisions, the two most important to Standard were the Navigation and Control Division and the Energy Control Division (JA 558-59, 893-94).

A. *Bendix Energy Controls Division*

Standard did substantial business with Bendix Energy Controls Division ("Bendix EC")—roughly 17-21% of its sales in 1965-68.[14] Bendix EC also was a manufacturer of airplane parts.

The margin of sales[15] for Bendix EC products prior to December 31, 1968 was 25.8-27.3% of the price to the air line customer (JA 1010).

On October 30, 1968, Bendix sent Bollo a letter (JA 1009) reducing the margin of sales on rotors stators and linings to 14.7-16.4% (JA 1010). This was a substantial change because rotors, stators and linings[16] constituted

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[14] Gross sales through Standard for the years 1965-68 and the percentage of total sales of Standard were as follows (JA 1008):

| | *Gross Sales of Bendix EC Products* | *% of Total Sales of Standard* |
|---|---|---|
| 1965 | $1,197,000 | 20.3 |
| 1966 | 1,416,000 | 21.5 |
| 1967 | 1,308,000 | 16.8 |
| 1968 | 1,769,000 | 19.4 |

[15] Bendix quoted prices in terms of discounts to a list price. In exhibits at trial and in this brief, Bendix's complicated discount setup has been translated into "margin of sales" as a percentage of the price to the airline customer in order to simplify and to facilitate comparison.

[16] Rotors, stators and linings were the "fast-moving items in brake parts" (JA 638). Jerry Bollo testified that these items were 80-85% of Bendix EC sales (JA 302). Louis Bollo testified that the percentage was only 60% (JA 733).

60-85% of the sales of EC products through Standard (JA 302). This change in discount rates was expected to reduce substantially the profits to Standard on the sales of this division; in fact, had the new rates been in effect in 1968, Standard would have lost as much as $157,000 in profit (JA 1011), or over 30% of the pre-tax profits of $495,471 for that year (JA 1213).[17]

Bollo's reaction upon receiving the letter was "This is the bulk of the product line. They are really hitting us hard" (JA 301-02). It was a permanent, not a temporary, reduction (JA 304).

The court held that the Bendix EC letter was *not* disclosed to PCC prior to the contract, finding not credible Bollo's testimony that he thought plaintiff "was informed" (JA 857).

The court appeared to accept plaintiff's factual presentation on this discount reduction and even found that it by itself represented an "arguably material development because of its impact on future earnings" (JA 857-58). Yet the court refused to find liability because of its conclusions that (1) plaintiff had access to the financial results of Standard's business operations and (2) plaintiff was aware shortly prior to the closing that Standard would have increased sales but decreased profits in 1969. The court reasoned that "The inference is inescapable that it either knew the reasons or considered them immaterial to its ultimate objectives in completing the acquisition" (JA 858) (footnote omitted).

We deal with these erroneous findings at pp. 27-36, *infra*.

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[17] A chart was introduced (JA 1011) showing the effect such a reduction would have had if it had been in effect in 1965-68 in order to show the importance of the communication to Bollo as of late 1968—early 1969.

B. *Bendix Navigation and Control Division*

Standard did substantial business in supplying products of Bendix Navigation and Control ("Bendix N&C"), also a manufacturer of airplane parts—over 18% of its 1968 sales.[18]

On April 11, 1969, Bendix sent Bollo a letter (JA 1012) officially notifying him that there would be *no* business for Standard on parts from Bendix N&C for the second-generation jet aircraft. The letter declared "With respect to our Navigation & Control Division's products for the 747, DC-10, and other new programs, we have decided that as of 1 May 1969 we will serve the airline aftermarket on a factory-direct basis rather than through our distributors."

The PCC witnesses testified that this news was not communicated to them. In fact, Putnam McDowell, president of First Grant Corporation in 1969, was told at a meeting with Bollo and others on May 9, 1969 (JA 975) that "Standard feels it is in an excellent position on the 747 program."

Bollo testified only that "I think they were informed on this, too." When asked who or when, his recollection dimmed: "Not really who or when. Probably at the meeting in Pittsburgh. But I am not sure" (JA 640-41). To the extent there was a conflict in testimony, the court did not resolve it.

The court, however, concluded that McDowell "was aware that big jet business would not be available to Standard." This erroneous conclusion was not based upon

[18] Gross sales of Bendix N&C products by Standard for the years 1965-1968 and the percentage of total sales of Standard were as follows (PX 16):

| | *Gross Sales of Bendix N&C Products* | *% of Total Sales of Standard* |
|---|---|---|
| 1965 | $ 501,000 | 8.5 |
| 1966 | 600,000 | 9.1 |
| 1967 | 949,000 | 12.2 |
| 1968 | 1,692,000 | 18.6 |

any testimony and will be discussed in detail at pp. 36-38, *infra.*

That Standard was being cut out of the second generation jet program from Bendix N&C also meant, as in the case of Whittaker, that Standard's entire distributorship of Bendix N&C products was in danger. In the uncontradicted testimony of Carolla:

> [This letter] tells me two things, and that is that my growth is not going to be there because they have elected to serve the airlines direct on the 747s and—well, second generation jets, if you will, in addition to which, again citing the same situation at Whittaker, it's not very logical for a company to handle one group of products that they have through distributors and another group of products on a direct basis to the airlines.
>
> Again I repeat, it doesn't make economic sense and it doesn't make operational sense, and it's only a matter of time and I'm afraid you aren't going to be handling anything, which, I might add, is the conclusion which I drew myself when I received the letter at Van Dusen.

(JA 462-63).

Prior to April 1968, the margin of sales of Bendix N&C products was 15.0-16.7% of the price to the airlines (JA 1007).[19] In April 1968, Bollo received from Bendix N&C a letter (JA 1005-06) reducing the discount on "commercial end items"[20] and "follow on spares" to the level of 2.2-4.2% of the price to the consumer (JA 1007). This letter effectively eliminated any net profit on these items, or, as Bollo himself said, "2½% is very little profit" (JA 721). The change in discount was permanent, not tempo-

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[19] See n. 15, *supra.*

[20] "End items" were synonymous with units, *i.e.*, complete parts ready to go on an engine or an airplane, such as a generator or a complete instrument (JA 546).

rary (JA 297). Bollo admitted that Bendix N&C did *not* tell him, either in words or substance, of any likelihood that the policy would change (JA 738).[21]

Although the court found that the change was limited to "units" and not "spare parts," the effect on Standard was severe because Bendix N&C unit business on the 747 was expected to be significant. Jerry Bollo testified (JA 291) that the sale of units was to become important with the provisioning of the second-generation aircraft. A good example was the $725,335 in actual orders (JA 1024-35) from Pan Am for Bendix N&C units which Standard had to cancel in May 1969 because they would not be profitable (JA 729-30). Had the sales margin of 15.0-16.7% prior to May 1, 1968 continued in effect, Standard would have realized over $108,000 in gross profit in 1969 from the Pan Am orders alone.[22] The court held that this reduction in discount was not disclosed to PCC (JA 857).

**3. *Epilogue***

On July 30, 1970, less than eleven months after the closing, Standard received a letter (JA 1066) from Whittaker giving official notice that the distributorship would be cancelled. The letter gave six months notice so that Whittaker would have no obligation to repurchase any of Standard's vast[23] Whittaker inventory. As a result of negotiations with Standard, Whittaker subsequently agreed (JA 1067) to permit Standard to continue selling Whittaker products from February 1, 1971 to December 31, 1971; instead of the previous discount rate of 15-22%, however, Standard was given a mere 10%, which was not profitable (JA 346).

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[21] This may be contrasted with the cases of the 707 and BAC 111, where discount cuts had been restored; in those cases, Bollo had been expressly told that the reductions were temporary (JA 736-38).

[22] This figure is obtained by multiplying $725,335 times the lower sales margin.

[23] In one of the internal Whittaker memos (JA 1000, 251), Glen Danks estimated Standard might be stuck with $200,000—250,000 of useless Whittaker material.

Even before the complete cutoff, the effect of splitting the product line was decreased sales. Sales of Whittaker products by Standard that had been $1,455,000 in 1968 decreased to $930,000 in 1969 and $627,000 in 1970 (JA 893-94).

On September 1, 1970, Bendix notified Standard that, beginning October 1, 1970, Bendix would no longer use Standard as a distributor to the airlines for any of its divisions (JA 1070).

Within a year after the closing, therefore, Standard was notified of the loss of the suppliers that composed over half of its business. It is the failure of Dollo to disclose the information known to him from which PCC could have reasonably anticipated those losses that lies at the heart of his violation of rule 10b-5.

**D. Inventory Overvaluation (Argument Point II)**

Standard was, in essence, an "inventory company" which, as middleman in the aircraft parts distribution network, stockpiled repair and replacement parts purchased from its suppliers,[24] and then delivered those parts to customers as orders came in. As the trial court observed, "By continuously maintaining large inventories around the country, Standard not only satisfied its suppliers, but also sustained good relations with its airline customers . . ." (JA 833) (footnote omitted). During the years 1965-69, the bulk (55-67%) of Standard's total assets was inventory (JA 1017).

With such a large volume of inventory, Standard, not surprisingly, inevitably found itself with greater quantities of certain inventory items than it could reasonably expect to sell. The question is whether that unsalable inventory was properly valued. The evidence showed that Standard carried on its books at full value large amounts of inven-

[24] Standard did not take products on consignment from its suppliers. Thus the products it purchased from its suppliers could not be returned if not sold by Standard to customers.

tory items which Standard had been unable to sell for years.

There was no dispute that inventory items which were probably unsalable had to be written off.[25] Nor, at trial, was there any dispute as to how much of such inventory was actually written off by Standard.[26] In controversy is only whether the amount of such inventory written off by Standard was sufficient to meet even the most liberal generally accepted accounting principles, *i.e.*, those principles establishing the minimum standards on inventory write-off policy and yielding the minimum permissible amount of write-offs.

Ernest Rushia testified that he was the person in charge of inventory and the one at Standard who performed the inventory write-offs at the direction of Bollo (JA 348-49) and that, in only four of the years in the period 1962 through 1968, did Standard write-off any slow-moving inventory (JA 352, 355-56, 361, 365). The amount of slow-moving inventory to be written off was selected arbitrarily. Rushia testified that Bollo simply picked a dollar figure and gave the dollar figure to him with no instructions as to which items to write off nor any explanation of how

[25] "Writing off" items is an accounting procedure whereby the value of the item on the company's books is reduced to zero by an appropriate credit, in this case, to inventories on the balance sheet and a corresponding charge to expenses on the income statement. If unsalable inventory is not written off, the assets of the company will be overstated and the expenses of the company will be understated (JA 389).

[26] The parties stipulated that the only inventory write-offs for slow-moving inventory were made by Standard as follows: 1962, $10,000.00; 1963, none; 1964, $21,600.02; 1965, $60,100.00; 1966 none; 1967, $45,285.15; 1968, none (JA 892-93). These write-offs, when made, were taken at year-end.

During the year, inventory items which were damaged or defective, lost, stolen, or ruled technologically obsolescent by the government were written off as the particular problem was discovered (JA 354, 383-84). The amount of these "spot" write-offs was insignificant and Standard did not keep any records of them (JA 350, 354).

Bollo had arrived at the specified dollar figure (JA 349-50, 365).

After being given the dollar figure by Bollo, Rushia would begin to go through the inventory records one-by-one, writing off items of which there had been no sales for at least two years—but only until he reached Bollo's predetermined number (JA 350, 357, 361, 365-66). No matter how many slow-moving items remained on the books—and Rushia testified there were always such items remaining (JA 353, 357, 361, 366)—Rushia would stop examining the inventory records at this point and write off no more slow-moving items that year (JA 353-54, 357, 361, 366) and report to Bollo that he had accomplished Bollo's instructions by finding the amount of money Bollo was looking for (JA 359, 375). In effect, Rushia was applying a "two-year rule" in writing off slow-moving inventory, but only on a small portion of Standard's total inventory.

The records of the write-offs are in evidence (JA 1013-16[27]), and, consistent with Rushia's testimony, show that only a handful of the ninety different product codes or lines stocked by Standard had been tested for slow-moving inventory (JA 353, 357, 366).[28]

Bollo's testimony contradicted Rushia's testimony in certain respects. Although Rushia specifically denied furnishing Bollo with information of any kind on which Bollo based the figure given him to write off (JA 349), Bollo claimed that Rushia would first give him a list of slow-moving inventory items which could be written off and other relevant information (JA 586). Bollo then supposedly selected the items from the list provided by Rushia

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[27] The recap or summary sheets are printed in the Joint Appendix. The complete records are on file with the clerk of this Court (PX 24-27).

[28] Rushia testified that in the four years from 1962 through 1968 in which there were year-end write-offs for slow-moving inventory items—1962, 1964, 1965 and 1967—he examined only three, two, fourteen and eight, respectively, of the ninety product codes in which Standard's inventory was classified (JA 353, 357, 361, 366).

to be written off on the basis of his experience and gave the list back to Rushia to perform the mechanics (JA 587).

The trial court did not state which of the conflicting versions it found credible. The trial court did not mention Bollo's testimony on the issue, however, but discussed the inventory questions in terms of the procedure testified to by Rushia (JA 872).

The evidence is undisputed that, had Rushia systematically reviewed Standard's entire inventory for slow moving items and continued to apply a two-year rule in writing off such items, instead of stopping at a predetermined figure when only a portion of the inventory had been reviewed, additional write-offs would have been made in the following amounts (JA 1018):[29]

| Year | *Becoming Deadstock During Year Ended December 31* | *Cumulative Balance at December 31* |
|---|---|---|
| 1961 | $ 318 | $ 318 |
| 1962 | 7,578 | 7,896 |
| 1963 | 9,223 | 17,119 |
| 1964 | 23,363 | 40,482 |
| 1965 | 27,253 | 67,735 |
| 1966 | 39,772 | 107,507 |
| 1967 | 76,258 | 183,765 |
| 1968 | 107,539 | 291,304 |
| 1969 | 126,034 | 417,338 |

[29] The figures in this chart represent the "most probable value" of additional inventory which became "deadstock" (*i.e.*, inventory items for which there had been no sales during the preceding two years) during the period 1962-69 and yet was not written off. These figures are drawn from a special study of Standard's inventory and inventory records performed by the accounting firm of Price Waterhouse & Co. ("Price Waterhouse study"). The Price Waterhouse study utilized certain statistical sampling techniques. Defendant-appellant introduced no evidence and adduced no testimony, expert or otherwise, which in any way challenged the validity of the techniques utilized or the accuracy of the results reported.

Expert testimony that the inventory accounting was inadequate was given by David Christopher,[20] a partner in the accounting firm of Price Waterhouse & Co. (JA 387-419) and Mr. Carolla (JA 465-77). Defendant offered no expert testimony or other evidence on the meaning of "generally accepted accounting principles" in this area.

Nonetheless, the court found in favor of Bollo as to this claim, a finding PCC submits is utterly unsupported by the evidence.

## ARGUMENT

### I.

### In Adjudging PCC's Rule 10b-5 Claims, the Trial Court Improperly Refused to Consider the Failure of Bollo to Disclose Material Adverse Developments Occurring Between Contract and Closing.

PCC was damaged because, at the closing on September 18, 1969, it paid a price far in excess of the true value of the Standard shares. Had Bollo revealed the events that had occurred and communications that he had received from suppliers up to that date—and, most particularly, between the date of the agreement on December 20, 1968 and the closing on September 18, 1969—the undisputed testimony is PCC would not have gone through with the closing and purchased the shares (JA 168-69, 171, 188-90, 106).

The trial court, however, refused to consider *any* events that occurred after December 20, 1968. The court held that *"for purposes of a Rule 10b-5 claim, events occurring after the commitment to purchase stock has been made are irrelevant."* Citing *Radiation Dynamics Inc.* v. *Goldmuntz*, 464 F.2d 876, 890 (2d Cir. 1972), the trial court stated:

> Issues of non-disclosure, misrepresentation, materiality and reliance are to be determined by the situation

[20] Christopher's qualifications are set forth at JA 387-88.

> and knowledge of the parties at the time they committed themselves, and not on the basis of subsequent events, even though they occur prior to "the formal closing date when the delivery and payment are formally completed and cleared."

(JA 861).

We have no quarrel with the decision in *Radiation Dynamics.* Events in that case had occurred before the formal closing but after the plaintiff had signed offers, irrevocable for a stated period, while defendants as buyers had signed unconditional letters of investment.[31] The plaintiff in *Radiation Dynamics* would have been required to go through with the closing even if he had been apprised of the concealed facts.

In the instant case, however, the sale of Bollo's shares to PCC was expressly subject to a number of conditions including: (1) that exemptions or approval of the Civil Aeronautics Board and the Securities and Exchange Commission be received *by June 30, 1969* (JA 901-03);[32] and (2) that representations and warranties made in the contract itself remain true and correct as of the date of closing (JA 904), including the warranty that "Since December 31, 1967, there has been no material adverse change in the financial condition or in the business or operations of Standard" (JA 900) and the warranty that the financial statements had been prepared in accordance with generally accepted accounting principles (JA 899-900).

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[31] In *Radiation Dynamics,* the issue arose because the trial court had instructed the jury that the date when materiality was to be judged was "the date when the parties committed themselves." This Court, on the facts of that case, held the instruction proper. The facts as to the irrevocable and unconditional nature of the commitment are found in Records & Briefs, United States Court of Appeals for the Second Circuit, 464 F.2d, Volumes 5 & 6 at 1139a-72a.

[32] The trial court had itself recognized that the failure to obtain the necessary governmental clearance by the prescribed date would relieve PCC of any obligation to go through with the purchase (JA 839).

Because the requisite approvals from the CAB and SEC were not obtained prior to June 30, 1969, the closing did not take place until September 18, 1969 (JA 839). The commitment to purchase Standard shares from Bollo and proceed with the closing at a later date was, therefore, not even pursuant to the December 20, 1968 contract but pursuant to the consent of PCC to extend the date of closing. As this consent was necessarily given after the material events that occurred in the January-May 1969 period, Bollo's failure to disclose those material events and communications is all the more telling since, had Bollo disclosed to PCC all that had happened, PCC would have been free, after June 30, 1969, not to go through with the closing.

As noted above, the obligation of PCC to purchase Standard shares from Bollo was also expressly "subject to fulfillment" of the conditions that there had been no material adverse change in the financial condition or in the business or operations of Standard and that the financial statements were properly prepared.

The trial court attempted to circumvent these latter two provisions by erroneously holding that, as

> The . . . "representations," [in paragraph 2] of the contract were obviously made on the basis of Bollo's knowledge as of December 20, 1968. . . . Rule 10b-5 liability could only attach if *on that date* the material facts incorporated in the representations were untrue or misleadingly incomplete to Bollo's knowledge at that time. . . .

(JA 862). This reading of the contract was simply inconsistent with the contract itself. Paragraph 6(d) of the contract states in pertinent part:

> The representations and warranties contained in Paragraph 2 of this Agreement shall be true and correct as of the Closing Date, *with the same force and effect as though they had been made at the Closing Date,* and there shall have been delivered to Purchaser

the certificate of Bollo, President of Standard, dated the Closing Date to such effect. . . ."

(JA 904).

The trial court in effect held that this paragraph meant only that the closing was conditioned on nothing having come to Bollo's attention prior to the closing which would have made the representations in paragraph 2 incorrect as of when they were originally made on December 20, 1968. But this interpretation would simply read out of the contract the language "with the same force and effect as though they had been made at the Closing Date" in paragraph 6(d).[33]

The recent decision of this Court in *Barnett* v. *Kirshner*, 527 F.2d 781 (2d Cir. 1975), demonstrates the conceptual flaw in the district court's ruling. In *Barnett*, the Court held that, as between buyer and sellers of stock, legal title passed upon delivery and payment, even though some consents to the sale were not obtained until a later date. But in its decision, the Court made clear that the basis was that "No reservation or condition is expressed in any of the papers" (*Id.* at 784) and that:

> [T]here was a completed sale of the stock on the days the shares were transferred and tnat the consent letters were separate and apart from the sales between the parties, in no way conditioning expressly or by implication the passage of title to the defendants.

(*Id.*) and that, unlike cases relied upon by the appellants therein, *Barnett* involved no transaction "where the promise

[33] If all warranties in paragraph 2 had been treated as if they were only required to be true as of December 20, 1968, then PCC would have been obliged to go through with the closing even had Bollo, after December 20, 1968, no longer owned "said shares free and clear of all claims and encumbrances" (¶ 2(a)); or even if Standard increased its capital stock (¶ 2(c)). We do not exaggerate: such an approach to the construction of this contract simply negates its most essential features.

was explicitly conditioned upon the performance of a condition precedent." (*Id.* at n.3.)

In this case, precisely what was lacking in *Barnett* is present; the agreement contains conditions and reservations which, unless properly met, would have relieved PCC of its obligations to proceed with the purchase at the closing; the closing document was not "separate and apart" from the initial agreement; indeed, the promises at issue here were—in the language of this Court in *Barnett*—"explicitly conditioned upon the performance of a condition precedent." That being so, the Court's ruling for Bollo was incorrect as a matter of law.

### A. The Materiality of the Undisclosed Adverse Developments

Having determined not to consider the most significant events occurring during the period between the agreement and the closing, the court analyzed the federal securities claim by isolating the pre-December 20 events and concluded that, by themselves, they were not material.

Although the court did not consider the post-contract events on the rule 10b-5 securities issue, the court went on to analyze those events in discussing the issue of common law fraud. As the standards for finding common law fraud are far more rigorous than those for finding liability under rule 10b-5,[34] especially in cases such as this one, where the principal violation was non-disclosure rather than affirmative misrepresentations, it cannot be assumed that the trial court would have reached the same conclusions had

[34] The court correctly so concluded:

> PCC concedes that these requirements [to prove common law fraud] are if anything more rigorous than the findings required for a Rule 10b-5 claim. And indeed they are, for it is settled under controlling New York law that the evidence of fraud "must be clear and convincing and the inference of fraud unequivocal."

(JA 864) (footnote omitted).

it been evaluating all of those circumstances in the context of rule 10b-5. Since plaintiff has already indicated that it will attempt to defend the court's rule 10b-5 ruling on the basis of its common-law fraud findings, in this section of the brief we nevertheless examine the court's reasoning and conclusions as if the court would have reached the same conclusions in making its decision on the rule 10b-5 claim. So viewed, the trial court's understanding of the legal standard of materiality and reliance, if carried over into the area of rule 10b-5, would be at odds with virtually every major federal securities law decision of this Court and the United States Supreme Court on those issues in recent years.

To begin with, the purpose of Section 10(b) of the Securities Exchange Act of 1934 has long been held to be that of deterring deceptive behavior in the purchase or sale of securities by ensuring full disclosure and fair dealing in all transactions, because informed decision-making is essential to sound investments and to the integrity of the market as a whole. *Chris-Craft Industries, Inc.* v. *Piper Aircraft Corp.*, 480 F.2d 341, 357 (2d Cir.), *cert. denied*, 414 U.S. 910, 924 (1973); *cf. Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151 (1972).

Examination of the trial court's handling of the evidence and statements of legal principles reveals several misconceptions of the requirements of the securities laws.

1. The trial court's overriding error was judging the question of disclosure in terms of what information was given to PCC, instead of what information was withheld. PCC's claim on the issue of supplier relationships was based on communications received from Standard's three largest suppliers, principally in 1968 and early 1969, which, by any yardstick, would have led a reasonable investor familiar with the aircraft parts supply industry to conclude that Standard's business was beginning, and would continue, to suffer substantial adverse change. Although PCC was given access to Standard's financial statements and

data, they were not shown the communications, nor told of the events behind these communications.

The financial statements and other basic financial data made available to PCC did not disclose nor even suggest the concealed communications. Yet the trial court repeatedly emphasized the large quantity of information which PCC's representatives had obtained: "There is not the slightest doubt that the financial results of Standard's business operations—the only material information of interest to PCC—were an open book. . . . Surveillance of Standard's financial health and progress became even more intensive as McDowell took hold and the day of closing approached." (JA 858).

The trial court took the erroneous view that Bollo's liability under rule 10b-5 was to be decided by the quantity of information given, rather than by the significance of information withheld. The court's opinion is replete with such statements as justification for its result, including that PCC "appears to have been fully cognizant of Standard's basic financial data over a considerable time period as well as its position in the field" (JA 836); that PCC sent representatives to Standard prior to the closing to make detailed studies of Standard's operation and organization (JA 849-50); that PCC "had unrestricted access to Standard's basic business data" (JA 863); and that PCC's representative (McDowell), prior to the closing, made detailed notes reviewing Standard's branch operations and business prospects (JA 870).

Indeed, the clearest example of the court's incorrect approach is its statement that McDowell's "detailed review," as reflected in his notes (JA 973-76), "is the most convincing evidence that nothing material was misrepresented or concealed from PCC" (JA 870). Inasmuch as the notes the Court refers to contain not even a hint of any of the communications and events which PCC claims Bollo failed to disclose, the trial court's strong statement makes no sense at all in terms of rule 10b-5 disclosure standards.

PCC's contention is not that its representatives were told little or nothing about the company that they were to buy (in fact, largely through their own diligence, they learned quite a bit), but rather that, despite all that they managed to learn, they were told *nothing* about the serious problems the company was confronting in terms of its most significant supplier relationships. That Bollo gave plaintiff detailed information about the company, including all of the good news (JA 1046, 1047, 1048, 1167-70), and at the same time concealed the bad news, only magnifies the significance of the non-disclosures. *Republic Technology Fund, Inc.* v. *Lionel Corp.,* 483 F.2d 540, 546-47 (2d Cir. 1973), *cert. denied,* 415 U.S. 918 (1974).[35]

The trial court made no reference to, and went far beyond, this Court's well established test for determining materiality, namely, whether a fuller, more accurate disclosure by Bollo would have prompted the typical investor under the circumstances to reconsider the terms of the purchase and, perhaps, pull out of the deal altogether. *Chris-Craft Industries, Inc.* v. *Piper Aircraft Corp., supra* at 362-63 (materiality for 10b-5 purposes focuses on the "weightiness of the misstated or omitted fact in a reasonable investor's decision to buy or sell" and is "concerned only with whether a prototype reasonable investor" would have been affected in light of all the surrounding circumstances); *Sonesta International Hotels Corp.* v. *Wellington Associates,* 483 F.2d 247, 251 (2d Cir. 1973) ("materiality of facts allegedly misstated or omitted depends, in turn, upon whether a reasonable investor might have considered them to be important" in making investment decision). See also *Gordon* v. *Burr,* 366 F.Supp. 156, 164-65 (S.D.N.Y. 1973) ("whether a reasonable man would attach importance to the fact misrepresented in determining his

[35] As stated by this Court in ***Republic Technology Fund:*** "the voters on the merger were being shown the frosting on the cake with no allusion in the statements to the fact that a substantial part of the cake itself was dried out, if not mildewed." (483 F.2d at 546-47).

choice of action" governs materiality in sale of stock and "material information need not be limited to information translatable into earnings").

Nor does the fact that undisclosed information relates to future "expectations" reduce the legal obligation to disclose. The contrary is true, since "material facts include not only information disclosing the earnings and distributions of a company but also those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company's securities." *SEC* v. *Texas Gulf Sulphur Co.,* 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969).

Bollo's failure to disclose basic facts—documents in existence or events which had occurred even though their impact was not merely immediate but prospective as well—wrongfully deprived PCC of precisely the opportunity that rule 10b-5 is designed to ensure of drawing upon its own informed and evaluative expertise in judging the wisdom and merits of the proposed investment. *SEC* v. *Texas Gulf Sulphur Co., supra,* 401 F.2d at 849. See, *Reeder* v. *Mastercraft Electronics Corp.,* 363 F.Supp. 574, 580 (S.D.N.Y. 1973); *Butler Aviation International, Inc.* v. *Comprehensive Designers, Inc.,* 307 F.Supp. 910, 913 (S.D.N.Y. 1969), *aff'd,* 425 F.2d 842 (2d Cir. 1970); *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 353 F.Supp. 264, 272 (S.D. N.Y. 1972), *aff'd,* 495 F.2d 228 (2d Cir. 1974).

The test may be stated in different ways. Whether it is couched in terms of ". . . [whether] a reasonable investor might have considered [the undisclosed or misrepresented facts] important in making his investment decision" (*Affiliated Ute Citizens* v. *United States, supra,* at 153-54 (1972); *Schlick* v. *Penn-Dixie Cement Corp.,* 507 F.2d 374, 381 (2d Cir. 1974), *cert. denied,* 421 U.S. 976 (1975)), or as "whether 'a reasonable man would attach importance [to the undisclosed facts or to the variance between the truth and the facts misrepresented] in deter-

mining his choice of action in the transaction in question,' " (*List* v. *Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied,* 382 U.S. 811 (1965)), the following facts which Bollo failed to disclose to PCC were, taken together, surely material:

(1) Prior to the agreement, Whittaker had at one point cancelled its distributorship agreement with Standard, had later established its own distribution division which was aggressively competing with Standard, and was seriously contemplating a total cancellation of the Standard distributorship;

(2) Between the agreement and the closing, Whittaker notified Standard, formally and informally, that it would not use Standard at all as a distributor for parts on second-generation jets;

(3) Prior to the agreement, Bendix N&C had sharply reduced its discount on what was expected to become a valuable segment of its product line;

(4) Between the agreement and the closing, Bendix N&C notified Bollo that it would not use Standard as a distributor for parts on second-generation jets; and

(5) Prior to the agreement, Bendix EC had sharply reduced its discount on 60-85% of its product line.

That PCC was given access to "financial data" of Standard, while the above facts were not disclosed, simply does not comport with the requirements of rule 10b-5.

2. The court's second misconception of the law was its holding that PCC had not relied upon the above non-disclosed information because, as the court suggested but never fully articulated,[36] PCC had some unstated investment objective in purchasing the shares of Standard, other than acquiring a company with healthy and profitable supplier relationships. Because of this investment objective, the court appeared to conclude, PCC would have purchased

[36] JA 835, 837-38, 868, 870, 886.

the shares at the same price, even if Bollo had disclosed that Standard's business prospects would plunge.

Not a word in the record, however, suggested any objective of PCC in investing in Standard stock which would not have been destroyed by the disclosure that Standard's profitability was in dire jeopardy. The objective, for example, of obtaining control of the company (JA 886 n.28) would have lost its desirability when the company's business prospects soured. The court's other example, the objective of seeking longterm appreciation in preference to income (JA 886 n.28), was hardly served by purchasing a company which has just been shut out of the second-generation market.[37] In any event, whether or not PCC had any motives apart from making money on its investment, PCC was surely damaged by paying a price far in excess of the true value of the Standard shares.

The court also made several references to how PCC's representatives "took full advantage of the protracted opportunity they had to examine the financial status of Standard" (JA 870) and of how they availed themselves of access to this information "to the extent considered pertinent" (JA 863). These references were cited in apparent support of a theory that what PCC "relied" on, it necessarily would have investigated and, if the investigation did not expose the particular fact, it must be because the purchaser did not give it sufficient importance.

This theory ignores, however, situations, such as this one, where the purchaser was told that supplier relationships were excellent and therefore had every reason to continue to rely on those representations through the closing. Indeed, under the prevailing interpretation of rule

[37] If anything, that PCC had a preference for long-term appreciation would make even more material to PCC facts relating to future, as opposed to existing, business. Yet the court apparently intended to discount the effect of the Whittaker and Bendix second-generation cut-off by emphasizing that these planes were "business not yet existing" (JA 879) and "in 1969, were almost a year away from delivery" (JA 867).

10b-5, PCC was entitled to rely upon Bollo to disclose any changes in the situation.

The role of "reliance" in a non-disclosure case is difficult to define with precision. As this Court itself stated in *Titan Group, Inc.* v. *F[illegible]ggen,* 513 F.2d 234 (2d Cir.), *cert. denied,* 423 U.S. 840 (1975), where the situation essentially involves "non-disclosure of material facts, even when coupled with access to the information, materiality rather than reliance becomes the decisive element of causation" (513 F.2d at 239). That is precisely the situation here.

In non-disclosure situations such as this, "reliance is an element of causation which plays little role" (*Crane Co.* v. *Westinghouse Air Brake Co.,* 419 F.2d 787, 797 (2d Cir. 1969), *cert. denied,* 400 U.S. 822 (1970)), and, in terms of reliance, "the test is properly one of tort 'causation in fact'" and no more (*Chasins* v. *Smith, Barney & Co.,* 438 F.2d 1167, 1172 (2d Cir. 1970)). As the Supreme Court ruled in *Affiliated Ute Citizens* v. *United States, supra,* at 153-54:

> "Under the circumstances of this case, involving *primarily* a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact." [38]

Contrary to the trial court's apparent belief (JA 870), more proof in terms of reliance is not required from plaintiff because PCC may have been a sophisticated investor, inasmuch as sophisticated investors, like all others, are

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[38] The trial court ignored all the cases in the Second Circuit adopting this position. *See, e.g., Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith Inc.,* 495 F.2d 228, 239-40 (2d Cir. 1974); *Cohen* v. *Franchard Corp.,* 478 F.2d 115, 124 (2d Cir.), *cert. denied,* 414 U.S. 857 (1973) (proof of actual reliance is not essential to a claim for damages involving nondisclosure).

entitled to the truth, and not just half-truths. *List* v. *Fashion Park, Inc., supra,* 340 F.2d at 463.[39]

In any event, the requisite reliance is clear from the record. All the testimony, including Bollo's, was that PCC was given glowing reports on Standard's prospects of increased business when the second-generation aircraft took the air. As the trial court itself observed, "Standard's hope for increased sales growth when the big jets began service was undoubtedly a frequent subject of discussion with PCC officials" (JA 866), and "Bollo undoubtedly hoped that the advent of the big jets would mean greater business for Standard. . . . PCC may have shared those expectations" (JA 879). Given the great emphasis placed upon this growth factor, not merely in the testimony of plaintiff's witnesses but also in contemporaneous memoranda prepared by them, it surely would have been a matter of critical importance to any purchaser to learn that Standard would be cut out of second-generation business by its major suppliers.

**B. The Question of Disclosure**

As to the fact that Bollo did not disclose the material information discussed above, on each issue there was either no adverse testimony or the trial court accepted the testimony of the PCC witnesses, with the possible exception of two areas discussed below.

For example, as respects Bollo's failure to disclose the contents of the Bendix N&C letter of April 1, 1968 or the Bendix EC letter of October 30, 1968 or the reductions

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[39] Although "Other circuits have apparently accorded greater weight to the plaintiff's background and expertise in determining reliance," in the Second Circuit, "our Court of Appeals has been loath to modify the reliance requirement to account for characteristics peculiar to the individual plaintiff." *Gordon* v. *Burr,* 366 F.Supp. 156, 166 (S.D.N.Y. 1973); *Barthe* v. *Rizzo,* [1974-75 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 94,741 (S.D.N.Y. 1974) (full and accurate disclosure is required even if dealing with a sophisticated investor in a purely private transaction).

in distributorship rates those letters effected, the court accepted "McDowell's and Johnston's testimony" (JA 857). As to several of the adverse Whittaker developments, Bollo offered no testimony on the question of disclosure. Both McDowell and Johnston testified that they had not been advised of the post-agreement, pre-closing Whittaker developments (JA 169-70, 160). Bonar testified that in July 1969 Bollo had told him that the relationship with Whittaker was "positive" (JA 208), and Bollo—having testified at depositions that he had *not* told PCC—could only testify at trial that he could not "say whether I told them or not" (JA 700, 704).

The court did draw two patently erroneous conclusions with respect to PCC's knowledge prior to the closing.

1. After resolving a conflict in testimony between McDowell and Johnston, on the one hand, and Bollo, on the other, by holding (JA 857) that Bollo, prior to the December 20, 1968 contract, did *not* disclose to PCC the cuts in Bendix discount rates (JA 1005-06, 1009), the court went on to hold:

> Surveillance of Standard's financial health and progress became even more intensive as McDowell took hold and the day of closing approached. PX 8; DX II, DX JJ, PX 9, DX D, DX G. Prior to the closing, PCC was well aware that even though Standard's sales in 1969 were likely to increase over 1968—which they did, PX 1, ¶ 7—its net income after taxes for 1969 would decrease about 60 percent. See p. 24, *supra*, and DX G. PCC apparently did not question this substantial decline and went ahead with the closing. The inference is inescapable that it either knew the reasons or considered them immaterial to its ultimate objectives in completing the acquisition.

(JA 858) (footnote omitted).

This inference was contradicted by *all* of the relevant evidence in the record, which showed that PCC was told that the reason for the decline in 1969 earnings was start-up

expenses associated with a connector facility that Standard had established in Kansas City. The best evidence of this is the certificate which Bollo provided to PCC on September 18, 1969 at the closing and which stated, and in fact warranted, as follows:

> Since December 31, 1967, there has been no material adverse change in the financial condition of the company as evidenced by most recent balance sheet information except that, as you know, *earnings in 1969 have been reduced due primarily to the investment in start up expenses of our Kansas City operation.*

(JA 919-20).[40]

The documents the court referred to contained absolutely nothing that would support an inference that either PCC knew of the discount reductions or would not have considered them material,[41] nor did any testimony support the court's inference.

2. The trial court expressed the conclusion that McDowell "was aware that big jet business could not be avail-

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[40] In addition, a memorandum written by McDowell on May 13, 1969 reported that he was told in a meeting with Bollo on May 9 that start-off expenses of new branches, including the Kansas City facility, were having an adverse effect on Standard's earnings (JA 973-74).

[41] In footnote twenty-one to its opinion, the trial court found as a fact that the reduced discount on Bendix N&C Brake and Wheel parts would have been "one of the reasons for the decline in earnings for that year" (JA 884). The court then stated: "It is thus impossible to believe PCC was unaware that the expected net profit on that new business as computed by Bonar, DX G, was at the then current reduced Bendix discount rate" (*Id.*).

If this sentence was intended to suggest that Bonar must have realized that there was a reduced discount rate, it is specifically contradicted by Bonar's notes. Those notes, taken on September 10, 1969, contain the entry "Wheels & Brakes . . . have higher Margins than traditional parts." Bonar would hardly have written this had he known that the margin on the "fast-moving brake parts" (JA 638) had been reduced to a level Carolla termed "marginal at best" (JA 462). There was no questioning or testimony on this point or these notes by either side or by the court at the trial.

able to Standard" (JA 869-70) by reference to a $725,000 Pan Am order placed with Standard for Boeing 747 unit spares from Bendix N&C.[42] This conclusion was not based upon testimony, but upon utterly unwarranted inferences from interpreting a memorandum and upon erroneous factual assumptions.

The trial court's reasoning, as best we understand it, was:

(1) "Standard's receipt of the order had been previously reported to PCC" (JA 869); (2) McDowell's memorandum summarizing the May 9, 1969 meeting listed Standard's needs for future additional working capital (JA 975) but "conspicuously absent" from such list was the Pan Am order (JA 869); (3) the Pan Am order would have required additional capital; (4) McDowell must have realized this; and (5) since he did not list it in his notes, McDowell must have either deduced, or been told, that the Pan Am order had been cancelled; and (6) if McDowell knew the order had been cancelled, he either knew why or had asked and been told the reason.

The court's analysis is simply unsupported by the record. There is no evidence that PCC had been told of the order; nor would the order have required investment of additional capital because, as the trial court itself noted (JA 847), the orders did not have to be delivered until well after they

[42] There was actually a series of orders issued between November 7, 1968 and February 20, 1969 totaling roughly $725,000 (JA 1024-35). Jerry Bollo testified that the orders had been received prior to April 11, 1969 but that, upon receiving the letter of that date from Bendix N&C, it was decided after consultation with Pan Am to return the orders to have them placed directly with the manufacturer (JA 309). The orders are in evidence only to show that: (1) Bendix N&C end items were to become after 1968 a substantial part of Standard's sales and therefore the discount reduction instituted by Bendix N&C on April 1, 1968 was material; and (2) Louis Bollo was lying when he testified that Bendix N&C had been ruled off the 747—"in fact, everything they made" (JA 728).

had been placed;[43] thus Standard had no need to stockpile these parts in inventory.

As the factual predicate of the court's analysis was in error, we need not protest the evident unfairness of the trial court's presuming that McDowell himself had information about the order or asserting, as a matter of law, that McDowell must have made the deductions the court so freely made. Finally, and perhaps most importantly, the trial court's conclusion concerning McDowell's knowledge is inconsistent with the following language from McDowell's memorandum which was not disputed and generally corroborated (JA 647) by Louis Bollo:

> Someone in the meeting estimated that when the 747's go into operation, the amount of Bendix and Whittaker equipment on these airplanes may result in annual sales volume of $250,000-300,000 per 747 for Standard Aircraft. Whether this applies to all 747's or only to those in certain areas was not made clear. The point is that Standard feels that it is in an excellent position on 747 program.

(JA 975).[44]

3. Another conclusion of the court which was not warranted by the record was:

> It was a matter of common knowledge that the big jets represented an enormous outlay of capital for the airlines and that their economic feasibility had yet to be tested. As the Bendix letter of April 11, 1969, PX 23, n.10, *supra,* plainly indicates, the airlines had prudently exacted from the manufacturers "such assurances as three-year product warranties . . . and ceilings on the cost of repair parts per flight hour." PCC, as

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[43] The orders called for delivery on August 15, 1969 (JA 847).

[44] Not only did Bollo not argue with the memo, but the court, in another part of its opinion, calls it "comprehensive" (JA 847) and implies that there was, in fact, a "lack of mention" by Bollo (JA 882 n.12).

> the owner of a commercial airline, could not have been unaware of these widely known industry developments and of their probable impact upon the role of distributors.

(JA 867).

From this language, it appears that the trial court concluded that: (a) certain assurances exacted by the airlines from the manufacturers were widely known industry developments; (b) PCC "could not have been unaware of them"; and (c) PCC must have been aware of their "probable impact" upon the role of distributors. There is not a shred of evidence, whether testimonial or documentary, in the record, not to say the court's opinion, to support any of these conclusions. In particular, we are at a loss to deduce how anyone—let alone individuals believed by the court to be "sophisticated" (JA 870)—who did know that the airlines had exacted from the manufacturers the assurances cited above would then conclude that distributors (such as Standard) would be cut off as a consequence! And it is, at best, anomalous to state that McDowell could not "have been unaware" of this conclusion when, in his memorandum of the May 9, 1969 meeting, he reported being told that Standard was in an "excellent" position on the 747.

* * *

As noted above, the basic legal error of the trial court was to interpret the *Radiation Dynamics* case so as to make irrelevant the events referred to in this action which occurred after the agreement was signed and prior to the closing. That error colors all else and it may be that the trial court would have ruled otherwise on questions relating to materiality and the like had it taken a different—and, we believe, more correct—view of Bollo's legal obligations under rule 10b-5. Whatever different conclusions the court might have reached, the ones it did reach are inconsistent with rule 10b-5 and should be reversed.

## II.

## The Trial Court Erred in Holding That Bollo Did Not Breach His Warranty That Standard's Inventory Had Been Properly Valued.

The argument for breach of warranty with respect to the overstated inventory of Standard may be succinctly summarized:

(1) both the contract (JA 899-900), and the closing certificate (JA 919) expressly warranted that Standard's financial statements (JA 922-72) had been prepared in accordance with "generally accepted accounting principles applied on a consistent basis throughout the periods involved" and that "all such statements fairly present the financial position of Standard as of the dates thereof";

(2) inventory was thus required to have been valued in accordance with "generally accepted accounting principles"; this was all the more critical, since inventory constituted so substantial a portion of total assets;

(3) proper valuation of inventory requires that adequate provision be made on a consistent basis to write off slow-moving inventory items that are probably unsalable; and

(4) the procedures actually followed at Standard with respect to inventory did not come close to satisfying that requirement.

The result of Bollo's breach was staggering. Inventory carried on Standard's books of over $381,000 at the time of the closing was virtually worthless and, applying even the most liberal accounting principles (*i.e.*, those which established the *minimum* standards and yielded the minimum write-off) to Standard's inventory, *should* have been written off. Hundreds of thousands of dollars more were of questionable value and, applying more conservative accounting principles, could have been written off.[45]

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[45] PCC has claimed only for the roughly $380,000 which the uncontradicted expert testimony established was the minimum *required* to have been written off.

**A. The Importance of Inventory Accounting**

Inventory represented the lion's share of Standard's assets. The following table, prepared from the balance sheets of Standard, was presented in evidence (JA 1017):

SUMMARY SCHEDULE—TOTAL ASSETS AND TOTAL INVENTORIES CONSOLIDATED

| *As of December 31* | *Total Assets* | *Total Inventories* | *Percentage of Total Inventory to Total Assets* |
|---|---|---|---|
| 1965 | $2,742,496 | $1,625,277 | 59.26% |
| 1966 | 3,389,604 | 2,181,782 | 64.36% |
| 1967 | 4,810,846 | 2,689,172 | 55.90% |
| 1968 | 5,105,541 | 3,392,076 | 66.44% |
| 1969 | 6,395,702 | 4,291,027 | 67.09% |

It was never disputed that a correct statement of the value of Standard's inventory was essential to a fair presentation in the financial statements of Standard's financial condition (JA 103-05; 392).

**B. Inventory Accounting at Standard**

Standard's financial statements in every case represented that inventory was being carried at the "lower of cost or market" (JA 929, 950, 967). This important accounting concept was explained by Christopher:

> "Lower of cost or market" is one of the generally accepted accounting principles which is applied to inventories. Basically, it's a rule that states that in the preparation of financial statements, inventory should be stated either at the company's cost for those inventories or, if the amount that will be realized from a third party upon sale of those inventories is lower or zero, the inventory should be stated at that lower amount.

(JA 407). Christopher testified that, notwithstanding the representations in Standard's financial statements, Stan-

dard's inventory had, in fact, not been carried at the "lower of cost or market" (JA 408) because, throughout the relevant period, Standard had continued to carry at cost on its books substantial numbers of aircraft parts having only slight or no probability of being sold: "I think the failure to make a complete and thorough evaluation of the entire inventory to determine all of the dead stock[46] obviously results in a failure to write down to the lower of cost or market the dead stock items that were not reviewed, evaluated and written off" (JA 408).

Under either Rushia's or Bollo's version of how slow-moving inventory was written off at Standard, there is no dispute as to how much was actually written off, nor that a complete and thorough evaluation of the inventory was not performed by Standard in any year, causing Standard's financial statements to be inaccurate and misleading. As Christopher emphasized, "generally accepted accounting principles would require a complete and thorough evaluation of the entire inventory and a write-off then based upon that complete and thorough evaluation" (JA 407).

Standard's write-off procedures, however, bore no relationship at all to generally accepted accounting principles. Standard wrote off no slow-moving inventory or dead stock in three of the years 1962-68 (JA 892-93). In the four years in which there were such write-offs, the amount to be written off was not determined in any conceivably proper way and failed to include all the slow-moving inventory which even the minimum standards of accounting required be written off. Although Standard's inventory consisted of approximately ninety different product codes during this period (JA 361), in 1962, only three of these product codes were even examined; in 1964, only two; in 1965, only fourteen; and, in 1967, only eight (JA 353, 357,

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[46] "Dead stock" was a shorthand term understood, by counsel for both sides as well as the witnesses, to refer to inventory as to which there had been no sales for two years (JA 362, 389). The term was not used, as suggested by the court (JA 886) to describe "all so-called unsalable parts."

361, 366; JA 1013-16). None of the other product codes were reviewed for slow-moving inventory and, in the seven years from 1962 to 1969, most of the product codes in Standard's inventory were not even reviewed. These facts are not disputed by Bollo.

The inventory write-off records in evidence (JA 1013-16 [PX 24, PX 25, PX 26, PX 27])[47] support Rushia's testimony that, at year's end (in the years that dead stock was written off at all), he would write off slow-moving items in Standard's inventory using a two-year rule but only until the artificial ceiling dictated to him by Bollo had been reached. Both Christopher and Carolla, PCC's expert witness on the aircraft parts supply industry, were of the firm opinion that this procedure would not adequately reflect the value of the inventory (JA 406-08, 466-67) and therefore would not be in accordance with generally accepted accounting principles; no countervailing evidence or testimony was introduced to show that that procedure was in any sense in accord with generally accepted accounting principles.[48] The court, therefore, should have concluded that Standard's financial statements, which incorporated these improper procedures together with the inaccurate results flowing from such procedures, were not prepared in accordance with generally accepted accounting principles (JA 406-07).

### C. Damages Due to Standard's Improper Inventory Accounting

To prove damages under the warranty theory, substantial evidence was introduced to establish the *minimum*

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[47] The joint appendix contains the "recap" or summary sheets for each year (JA 1013-16). The complete inventory write-off records are on file with the clerk of this Court (PX 24-27).

[48] It is striking that defendant introduced no accounting testimony and that not even the accountants who certified to the financial statements in question were called by Bollo to testify in support of their accuracy and propriety. In Bollo's answers to PCC's interrogatories prior to trial, PCC was informed that an accountant from Standard's former auditors would testify on Bollo's behalf (JA 68-69). At trial, no such testimony was proffered.

amount of additional inventory that should have been written off consistent with generally accepted accounting principles. According to the uncontradicted expert testimony given at the trial, Standard's practice regarding slow-moving inventory violated generally accepted accounting principles for companies with substantial repair parts inventories (JA 416-17), thus resulting in overstated assets and understated expenses (JA 389, 423) which, in turn, resulted in overstating Standard's income, inflating the price paid by PCC for Standard's stock (whether on the basis of a price-earnings ratio or on a net assets basis) and overstating the true value of Standard's inventory acquired by PCC.

Even Bollo's testimony does not dispute that inventory which would have been written off applying a two-year rule on a consistent basis was not written off. The undisputed evidence showed that had Rushia not stopped upon reaching Bollo's predetermined number but continued to apply the two-year rule to the entire inventory in each year, there would have been the additional write-offs of $183,765 as of December 31, 1967; of $291,304 as of December 31, 1968; and of $381,082 as of the date of the closing on September 18, 1969 (JA 405-06).

**D. Opinion Below Regarding the Warranty Claim for Inventory**

The trial court agreed that Bollo had warranted that Standard's inventory was properly valued:

> To be sure, in acquiring Standard, PCC relied in part on 'financial statements' furnished by Bollo for the years 1965 through 1969, PX 4, 5, 6 and DX KK and LL, and had the right to treat them as fairly presenting Standard's inventory values and financial condition at the close of each annual period.

(JA 875).

Having come to this conclusion, the trial court went on to hold, erroneously, that Bollo did not breach his warranty with respect thereto.

The trial court's opinion denying liability on this point first observes that the "evidence on the subject of inventory write-off policy was both conflicting and confusing" (JA 852). Yet the trial court totally failed to resolve any such conflicts: more significantly, in discussing the warranty claim, the trial court repeatedly relied upon considerations relevant only to those claims based on fraud or misrepresentation and occasionally on considerations of no relevance to any of the grounds for recovery.

The crux of the court's rationale for denying the breach of warranty claim was the following:

> The claim here, however, is not really directed to the accuracy or adequacy of the financial statements. Rather it challenges the business judgment of Standard's management in not taking greater advantage of liberal write-off opportunities at the close of each year. Such criticism, in hindsight, may be justified. It is no basis, however, for construing 'generally accepted accounting principles' as a warranty that all inventory which might have been written off was in fact so treated on the company's books.

(JA 876-77).

This analysis simply misses the mark. The trial court found, quite correctly, that periods ranging from six months to two years are used by companies in the aircraft parts supply industry as the basis upon which to write off slow-moving inventory and that, furthermore, selection of an appropriate period within this range is a matter of business judgment:

> David Christopher, a partner of Price, Waterhouse & Company, PCC's outside auditors, while expressing the belief that Standard's 'methodology' was not consistent with generally accepted accounting principles, conceded there was no accounting textbook authority for writing off inventory in any given period of time as expressed in a two-year rule, a six-months rule or the like. Tr. 338-40. And William Carolla, the former

president of one of Standard's major competitors, n. 17a *supra,* thought that a write-off formula, within the range of six months to two years, based upon business judgment would not be unreasonable. Tr. 433.

(JA 878). And the trial court stated, again correctly, that Standard and Bollo were at no time legally obligated to write off all of the slow-moving inventory that they possibly could have. But the amount that possibly *could* have been or *"might"* have been written off from Standard's inventory is not, and was never, at issue.

Instead the question is, and always was, how much of Standard's slow-moving inventory *should* have been or *must* be written off. At issue is not the amount of write-offs which conservative accounting principles would allow (this being, in fact, a matter of business judgment) but the amount of write-offs for slow-moving inventory which the most liberal accounting principles simply require. The *only* expert testimony—from both expert witnesses—was to the effect that a two-year rule was the longest permissible period, established the absolute minimum standard, and yielded the smallest amount of write-offs acceptable. That being so, the trial court erred in its ruling to the contrary.[49]

The only specific point made by the trial court with respect to the meaning of "generally accepted accounting principles", apart from misunderstanding the role and

[49] In addition to having apparently confused minima with maxima, the trial court appeared to be under the erroneous impression that a more conservative six-month rule would result in less inventory being written off than would a two-year rule (JA 877-78). This is simply inaccurate since the longer the period, the smaller the write-off. Thus a six-month rule would result in far more inventory being written off then a two-year rule. Plaintiff contended that Bollo's liability for breach of warranty flows not from mere failure to write off everything that *could* be written off but rather, from his failure to write off at least the amount which *must* be written off and the uncontradicted evidence was presented accordingly.

effect of a two-year rule, was its assertion that "PCC's expert computer methods of inventory control cannot be made the standard for construing 'generally accepted accounting principles' and imposing liability for breach of warranty upon Bollo" (JA 878a). Here again, however, the trial court has misunderstood the uncontradicted evidence. At trial, Christopher, PCC's expert accounting witness, had used a computer to assist him in calculating the total amount of inventory that would have been written off over the relevant period had a two-year rule been consistently followed. There was no contention that Standard should have used, and there was no evidence that Standard needed to use, a computer to assist it in making write offs. Neither was there any contention that generally accepted accounting principles required a computer. Christopher emphasized that generally accepted accounting principles did require a "complete and thorough evaluation" of the inventory (JA 406, 407); there is no evidence whatsoever in the record that a computer need be used to accomplish that "complete and thorough evaluation." In fact, the four annual write-offs that were done at Standard in the period 1962-1968 were accomplished without substantial assistance by a computer.

All of the trial court's other comments with respect to inventory relate either to the question of liability on the basis of fraud or misrepresentation or else are irrelevant to the legal theory underlying liability for breach of warranty and are, in any event, without warrant in the record. For instance, the trial court stated:

1. The verification procedures[50] of Standard's former independent auditors "appear to be consistent with gen-

[50] These procedures referred to in the exhibits the court cited were tests of the physical inventories (*i.e.*, whether the total number of parts listed on the inventory card matched the number physically present on the shelf); and "pricing" of a few test items, which was not defined but presumably involved verifying that the items were entered at cost and that a first-in, first-out basis was used to calculate inventory values after a sale. There was *no* indication in any of the exhibits referred to that any tests

erally accepted accounting practice" (JA 873)—not only was this not the question, but Standard's former accountants were not called to testify on Bollo's behalf to define "generally accepted accounting principles" of any kind, or to defend Standard's inventory write-off policy. Indeed, Rushia testified that Standard's former accountants never discussed inventory write-off policy with him in auditing Standard's inventory and never asked him how he performed his function of write-offs (JA 383, 385).

2. A portion of the inventory consisted of so-called "insurance" items,[51] and because Standard sold parts which were "not perishable items (except for deadstock)," [52] it was "not unreasonable to retain them in inventory for longer periods than two years based upon the experience" of Standard's management (JA 872-73). That an occasional item may be sold several years later cannot justify carrying huge amounts of slow-moving inventory *on the books* at full value. Such inventory may be physically retained for longer periods than two years and not simply thrown away (JA 363), but the trial court simply failed to appreciate that when a part is physically junked and when a part is to be written off the company's books are not the same thing. How such slow-moving inventory is to be valued is a matter of accounting and subject to accounting principles.

3. PCC "had no interest" in the state of Standard's inventory until late in 1970 (JA 878). This unwarranted assertion is belied by, among other things, the presence of an extended discussion of Standard's inventory and in-

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were conducted to identify or write off slow-moving inventory (JA 929, 950).

[51] Parts infrequently or rarely required but productive of good-will when available to that rare customer who needs them in a hurry (JA 872). There is no evidence in the record that insurance items were more than a *de minimis* part of inventory.

[52] This is another instance of the court's confusion over the term "deadstock" equating it with "perishable items."

ventory write-off policy in Bonar's contemporaneous memo (JA 979-80) which records what he had been told by Bollo in July 1969 and which, in the words of the trial court, "covers . . . inventory policies and control," among other things (JA 850). It was not until late in 1970, however, that PCC realized that something was amiss.

4. PCC wrote off additional amounts of inventory in 1970 for reasons other than a two-year rule (JA 878a). The decision to write off excess inventory and other items in accordance with accounting principles more *conservative* than the most liberal rule does not change the fact that PCC is seeking damages from Bollo *only* for inventory which should have been written off, but was not, under the most liberal accounting principles, *i.e.,* the two-year rule.[53] The $381,000 figure represents this minimum required write off and nothing else.

5. Standard's write-off procedure was "undeniably haphazard" but not out of keeping with a small company (JA 877). Whatever importance this factor had to the trial court in reaching its decision, it, like the others above, has absolutely nothing to do with the question of whether the financial statements which Bollo warranted as accurate were prepared in accordance with "generally accepted accounting principles."

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[53] Although PCC claims that Bollo's failure to write off slow-moving inventory was a breach of warranty which made it necessary to write off those items in 1970, it has *not* claimed, contrary to the trial court's assertion (JA 876), that Bollo's failure made it necessary to write off "excess" stock and items "considered unsalable because of the Bendix cancellation." The court was also incorrect in stating (JA 878a) that the latter two categories were included in the $444,247 and $178,649 inventory write-offs in 1970. Those two write-offs consisted only of items for which there had been no sales for two years (JA 1273-76).

## CONCLUSION

The decision of the trial court should be vacated and the case should be remanded to the trial court for an assessment of damages.

Respectfully submitted,

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UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

---------------------------------------X

PITTSBURGH COKE & CHEMICAL COMPANY, :

Plaintiff-Appellant, : 76-7565

-against- :

LOUIS J. BOLLO, : AFFIDAVIT OF SERVICE

Defendant-Appellee. :

---------------------------------------X

STATE OF NEW YORK )
: ss.:
COUNTY OF NEW YORK )

THOMAS M. DOYLE,JR., being duly sworn, deposes and says:

1. I am over the age of 18 years and not a party to this action.

2. On the 7th day of February, 1977, I served two copies of the Brief Of Plaintiff-Appellant, along with one copy of the Joint Appendix (volumes 1 & 2) and the Trial Exhibits upon:

PAUL, WEISS, RIFKIND, WHARTON&GARRISON
345 Park Avenue
New York, New York 10022

by causing true and correct copies to be hand delivered and left at the offices of the aforementioned attorneys.

Thomas M Doyle Jr

Thomas M. Doyle, Jr.

Sworn to before me this

7th day of February, 1977

Robert Bellavia

ROBERT F. [illegible]
Notary Public, State of New York
No. 31-4625831
Qualified in New York County
Commission Expires March 30, 1978